OUTLOOK FOR FINANCIAL MARKETS as at 1/9/20

Economies:

Negatives:
- Businesses in lockdown translate into high unemployment / underemployment. The big problem with this is there are too many unproductive people meaning there are less goods and services being provided. In economic parlance this is referred to as a recession. During a recession, many businesses have lower revenues and profits, and some won't survive (*bankruptcy*).
- At the same time there seems to be a trend towards deglobalisation and nationalism, resulting in a reduction in world trade which also has had negative implications (*either directly or indirectly*) for many businesses.
- Health issues, domestic violence, crime and racial unrest.

Positives
- Record low interest rates.
- Low inflation.
- Central Banks using unconventional monetary actions (*eg. Quantitative Easing*) to support financial markets.
- Massive Government Fiscal support from all countries.

Dealbreakers
- Hopefully soon, there will be vaccines or successful treatments for COVID-19. This will enable the removal of lockdowns, reopening of shuttered businesses and the regeneration of economic growth, although no one seems to know just how long it will take to fully recover.

Not all Businesses are Impacted Equally by the Shutdowns

Badly Impacted
- Those reliant on travel such as Airlines, Airports, Casino's and Accommodation providers.
- Restaurants and entertainment facilities such as cinemas / theatres, large scale events (*including sports*).
- Large shopping centre owners and some of their tenants e.g. fashion stores.

Beneficiaries
- On-line sales
- Some Industrial and office properties with AAA tenants (e.g. Government departments) on long term leases.
- IT Suppliers, Cloud facilities, some supplier's / manufacturers of medical equipment and pharmaceuticals.
- Producers of food (*you have to eat*) and supermarkets
- Home delivery services
- Iron Ore and Gold Miners (*these minerals are in high demand at present*).

Australian Shares

Reporting season for companies listed on the ASX has just about finished. Profits on average were down quite a bit due to the COVID-19 shutdowns, but this was expected. More companies surprised on the upside than those that were below expectations. A decent number of companies held their profits and, in some cases, even increased them. Some companies' profits are only likely to be impacted in the short term, but some will have some longer-term negative impacts.

The current average Price to Earnings (*P/E*) ratio for the Australian share market is around 19 (*share prices around 19 times earnings per share or the equivalent of earnings of 5.26% on a companies worth as judged by the share market – Number of shares issued x the price per share = a company's market cap)*. The long-term average for Australian P/E ratios is around 14.5 to 15 but interest rates have never been this low, so higher P/E ratios can be justified to some extent.

That said, Australian share prices on average are in my opinion marginally expensive. But if you drill down into the component parts, you will find that some prices are very expensive, some are fair value, and some are cheap. The prices in some cases are very distorted. So it is still possible to make good returns from investing in Australian shares over the medium and long term by populating your portfolio with quality cheaper stocks or if you hold expensive stocks, be clever enough to bail out of them before the tide turns and they start falling – its hard to get the timing right so maybe best to avoid these types.

Please note that P/E ratio's have their limitations in measuring whether share prices are cheap or expensive and companies that are growing their profits significantly each year can justify higher P/E's than those that are barely growing at all or have shrinking profits. For example a company like CSL (*P/E of 41*) which has grown its profits 300% to 400% over the last 10 years and is still growing, can justify a much higher P/E than an expensive stock like Woolworths (*P/E of 30*) whose profits have decreased over the last 10 years and don't look like increasing much (*if at all*) in the near future.

Global Share markets

USA shares have been the best performing developed country share market in recent years but using the S & P 500 index as a guide, US shares look expensive. Just 5 stocks make up 25% of the index (*Apple, Amazon, Alphabet (Google), Facebook & Microsoft*) and all of these to a degree appear expensive by normal criteria (*such as P/E ratios*). Therefore, they account for most of the better performance of the US market in recent times. Take them out and the US looks like a bit of a mixed bag. There are still stocks that look very expensive, but the number of listed stocks in the USA is very large and there are still plenty of shares whose prices represent good value, particularly from the small to medium size stocks. Other countries share markets are similar in terms of having a wide dispersion between the pricing of shares – expensive to cheap. So, with global shares it's important to be selective in which shares are held by investment funds and to also be active, when required, in running global portfolios.

Fixed Interest

I find it hard to justify having much exposure to this sector at this point in time. Interest rates are crazy low and if they increase, the value of fixed interest securities will fall (*higher falls for longer terms*).

In Australia, the Reserve Bank's official target / cash rate is just 0.25% and on call bank accounts are in most cases paying less than this. Twelve-month term deposits offered by Australia's big 4 banks range from 0.6% to 0.75% per annum Australian 10-year Government Bonds are only yielding around 1% per annum for 10 years. Semi Government Bonds aren't paying much more e.g. Treasury Corp of Victoria offering 1% per annum for 4 years and NSW Treasury 0.68% per annum for 7 years. Unsecured Corporate Bonds are also offering low returns e.g. ANZ and NAB yielding 1.65% for 5 years or GPT yielding 2.85% for 12 years. Major bank capital notes / convertible preference shares, which rank below unsecured corporate bonds in the event of a windup, are trading on yields to maturity of between 2.4% to 3.9% (*the higher ones are where there are still 5 to 6 years till maturity*).

In the USA, Europe, and Japan the interest rates payable are similar to Australia or less. However, Global exposure has more variety to choose from and various currency exposures when they are not hedged (at a cost) back into $A. Active management can add value when done well because of trading opportunities available with much larger markets and options to choose from.

Property - Australia

The outlook for residential property does not look especially good (*residential property prices usually fall when there is a recession*).

The outlook for Retail properties (*large shopping centres*) is negative.

Accommodation for travellers / Hotels (not pubs) outlook is negative.

Office properties are a bit of a mixed bag. Some look to have problems but others look good (those with quality buildings, in good locations, with AAA tenants on long term leases with good rental yields and automatic increases to rent each year, low or no vacancies and conservative borrowing - yes these do exist).

Industrial properties – the same explanations as with office properties. Note industrial properties have been boosted by increases in on-line shopping.

Australian Listed Property looks to be better value now after the February / March sell off shaved over 40% off prices. Still need to be selective – those listed property trusts which share the better features mentioned above should do well over the next few years (*yields are in the 5% to 8% range*).

Property - Global

Similar comments to the above can be made regarding Global property markets although some overseas residential property markets look solid (*probably because their prices weren't as stretched as here in Australia*). Yields on listed global property trusts are probably lower than Australian (*although APN Asian REIT Fund is yielding around 5.9% income*).